



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations

1100 Commerce Street, MC 4920 DAL

Dallas, TX 75242

501.03-00

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

September 13, 2012

Number: **201252021**

Release Date: 12/28/2012

LEGEND

ORG - Organization name

XX - Date Address - address

Taxpayer Identification Number:

Person to Contact:

Identification Number:

Contact Telephone Number:

ORG

ADDRESS

CERTIFIED MAIL

Dear

This is a final adverse determination regarding your exempt status under section 501(c)(3) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated August 4, 19XX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, 20XX.

The revocation of your exempt status was made for the following reason(s):

You are not operating exclusively for any charitable purpose, educational purpose, or any other exempt purpose. Our examination reveals that you are not engaged primarily in activities which accomplish charitable, educational or other exempt purposes as required by Treas. Reg. 1.501(c)(3)-1(c)(1). Your activities, including your financial transactions, more than insubstantially furthered non-exempt purposes. Moreover, you failed to establish that you were not operated for the benefit of private interest of your president, vice president, treasurer and secretary as required for continued recognition of exemption pursuant to Treas. Reg. 1.501(c)(3)-1(d)(1)(ii). Your income inured to the benefit of private shareholders and individuals.

Contributions to your organization are no longer deductible under IRC §170 after January 1, 20XX.

You are required to file income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the tax year ended December 31, 20XX and for

all tax years thereafter in accordance with the instructions of the return.

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination under the declaratory judgment provisions of section 7428 of the Code, a petition to the United States Tax Court, the United States Claims Court, or the district court of the United States for the District of Columbia must be filed before the 91st Day after the date this determination was mailed to you. Please contact the clerk of the appropriate court for rules regarding filing petitions for declaratory judgments by referring to the enclosed Publication 892. You may write to these courts at the following addresses:

You also have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Nanette M. Downing
Director, EO Examinations

Enclosure:
Publication 892

Internal Revenue Service

Department of the Treasury

Date: April 24, 2012

ORG
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended December 31, 20XX

LEGEND

ORG - Organization name XX - Date State - state Founder - founder
RA-1 & RA-2 - 1st & 2nd RA CO-1, CO-2, CO-3, CO-4, CO-5, CO-6 & CO-7 - 1st,
2nd, 3rd, 4th, 5th, 6th & 7th COMPANIES

Issue: Whether the exempt status of ORG should be revoked.

Facts:

ORG (the organization or Organization) applied for exemption under IRC Section 501(c)(3) in January, 19XX and was granted exemption on August 4, 19XX. Records indicate that the organization has filed Form 990, Return of Organization Exempt From Income Tax, for each year until 20XX. The 20XX return is not yet due.

Documentation from the State of State shows that the organization was incorporated in State in 19XX.

The exempt purpose of the organization is to provide psychological counseling and therapy to individuals and families affected by drug addition, alcohol, or violence. The examination found that the organization did provide psychological counseling and therapy consistent with the exempt purpose of the organization.

Prior to the examination Founder experienced a stroke and was unable to provide many answers to questions during the initial interview. Several times she stated she did not understand the question being asked. She was also unable to provide many of the requested documents. She stated that they could not be located. Because of this much of the information determined during this examination was obtained from the banks statements, credit card statements, financial statements, and general ledger.

During the initial interview on August 16, 20XX Founder stated that she held all of the organization's officer positions (President, Vice-President, Treasurer and Secretary) and provided all of the independent oversight of the organization. In addition it was found that Founder controlled all of the organization's bank accounts and made all of the transfers from the bank accounts.

Founder also owns % of the stock of CO-1 (CO-1) a for-profit psychology practice. This practice provides counseling similar to the services provided by the organization.

In 20XX ORG retained CO-2 (CO-2) to perform write up (data entry) services and produce a general ledger, financial statements and prepare their tax return. RA-1 is the owner and president of CO-2 and served as the representative of ORG for the examination. RA-1 retained RA-2 (RA-2) to actually perform the write up/data entry service. It is not known whether RA-2 is a W-2

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employee of CO-2 or an independent contractor. RA-2 had a desk and work area in the CO-2 office as of 20XX. RA-2 was interviewed after the initial interview.

During the initial interview RA-1 did provide basic information but was unable or unwilling to provide an extensive amount of specific, detailed information regarding the organization's operations or activities.

On a regular basis the organization provided RA-1 with bank statements. These bank statements were used by RA-1 and RA-2 to prepare the general ledger, financial statements and tax returns.

After 20XX the activity of the organization decreased significantly and has had very little or no activity. This was due to Founder health. Returns filed by the organization show that some activity occurred but less than previous years.

During the bank deposit analysis it was found that all of the earned receipts were paid by the State of State. The organization incorrectly indicated on Form 990 for 20XX that they were "government contributions." In fact, they were payment for services rendered.

One problem with the Form 990 noted during the examination was that the face of the return shows an excess of revenues over expenses in the amount of \$ yet the assets decreased by more than \$. Because there were no liabilities on the balance sheet it would be expected that the assets would increase rather than decrease.

Activities

One of the objectives of the examination was to determine what charitable activities were performed by the organization. This would include providing services to the public free of charge. During the initial interview Founder stated that some people were seen for free. Nothing was seen during the examination that supported this statement. Fees were charged for all services provided and nothing was seen that differentiates this organization from any other psychologist practice.

Inadequate records

During the examination the organization failed to provide records which were adequate to support the information shown on its' Form 990 for 20XX.

Some records, such as some credit card statements were simply not available. Other records were contradictory. For example, a bank deposit analysis of the primary business account of the organization was performed and found that, net of transfers to the organization's savings account, the amount of expenditures totaled \$; the general ledger showed expenditures of \$; the year end

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financial statements showed expenditures of \$; and the Form 990 showed expenditures of \$. The records provided could not explain the differences in these amounts. The bank statements flatly contradict amounts shown in the year end financial statements and general ledger. Of particular concern was that the Form 990 failed to reflect an account receivable from Founder' for-profit company of \$. The account receivable was shown in general ledger and year end statements.

As was stated above, the general ledger, financial statements, and Form 990 were all prepared by RA-1, the organization's preparer. RA-1 was asked about these differences and was unable or unwilling to provide an explanation. No explanation for these differences was ever received.

Inurement

The examination of expenditures found that a large amount of inurement occurred in several ways. Personal expenses of Founder were charged on credit cards and the organization paid the credit card bills. This occurred regularly throughout 20XX. Transfers were made to a number of bank accounts including Founder personal bank accounts and to bank account of Founder for-profit company, CO-1.

Most of the credit card statements were not available but the statements of an CO-5 credit card were provided. Because of the large number of transactions on this account a sample of three months of activity was selected for analysis. This analysis found that % of purchases were of a personal nature and were not made in the pursuit of the organization's exempt purpose. The personal purchases were to such places as CO-3, CO-4, restaurants, and gas stations.

In addition to the credit card purchases, Founder made seven transfers from the organization bank account to her personal bank account (account number ending in #) in the amount of \$. Founder was not provided a Form 1099-MISC or W-2 and no explanation for these transfers was ever determined.

The organization also made numerous transfers to the bank account of Founder for-profit practice. These totaled \$. The organization filed a Form 1099-MISC reporting \$ paid to the for-profit company but there was never any explanation regarding why the payments were made. In addition, the \$ difference was not explained.

There was no written documentation or oral testimony obtained during the examination which would explain how any of these disbursements benefited the organization or otherwise helped the organization achieve its exempt purpose.

Oversight and Internal Controls

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The most significant problem observed during the examination was the complete lack of any oversight or internal controls. There was no independent oversight board in place with the organization to provide guidance to the officers. In addition, Founder had given herself the positions of President, Vice President, Treasurer and Secretary. This is seen on page sixteen of the Articles of Incorporation. These conditions lent themselves to financial problems.

As far as could be determined Founder was the only person in control of the organization. There were no employees or independent contractors. It is believed that the work of the organization was performed by the employees of Founder for-profit practice. During the examination RA-1 was asked about some of the discrepancies found in the books and records. RA-1 referred to the bookkeeper, RA-2, who stated that any transfers to Founder or her for-profit practice were classified as a loan. RA-2 stated that the reason he did this was because he felt this was the most appropriate treatment. According to RA-2 he was not aware of any formal or written loan agreements and was not aware of any interest charged for the loans.

Law:

IRC Section 501(c)(3) states "Corporations, and any community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities or which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) and candidate for public office."

Reg. 1.501(c)(3)-1(d)(1)(ii) maintains that the organization must demonstrate that "it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests." This regulation goes on to specifically identify officers of the organization, such as the president or treasurer, as individuals who can not benefit from inurement.

Treas. Reg. 1.501(c)(3)-1(c)(2) states that an organization is not operated exclusively for one or more exempt purposes if any of its net earnings inure in whole or in part to benefit of any shareholder or individual.

IRC Section 6001 requires taxpayers to keep and maintain records adequate to determine whether or not an organization is liable for any tax covered by the Internal Revenue Code.

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Reg. 1.6001-1(a) says that "Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax or information."

IRC Section 6033(a) states in part "every organization exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe..."

Discussion:

As far as could be determined, during the year under examination the organization operated in a commercial manner. Patients were seen and the State of State was billed on a fee for service basis. The only difference was that the organization billed the state for fees earned rather than billing the patient or an insurance company.

Despite the fact that Founder stated some patients were seen for free no evidence of this was seen during the examination. It is possible some patients were seen by Founder for-profit practice and that she simply confused the exempt organization with her for-profit practice. In any event, nothing was seen during the examination that showed the exempt organization ever treated any patients for free or otherwise engaged in any charitable activities.

Another area of concern was the adequacy of the records. The preparer, RA-1, had access to all of the organization's banks statements and nothing prevented him from preparing a complete and accurate general ledger and year end financial statements. Despite this there were very large differences between the general ledger, year end income statements and balance sheets, and the organization's Form 990. The bank statements clearly showed expenditures of over \$ yet the return showed expenditures of less than \$. The year end balance sheet (in the financial statements) showed a receivable from Founder for-profit practice of more than \$ yet this was completely omitted from the balance sheet on Form 990. When questioned about this RA-1 was unable or unwilling to explain how this happened.

Perhaps the most significant area of concern is the matter of inurement. The examination revealed that a large amount of inurement occurred and that Founder treated the organization as her own personal checking account. Several methods of inurement were seen. The organization's bank account statement show that transfers to her for-profit occurred shortly after the funds

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became available. There was no pattern of payment regarding the transfers. Sometimes the transfers occurred near the beginning of the month, sometimes in the middle of the month, sometimes near the end of the month. Sometimes transfers to the for-profit account happened once a month, sometimes twice a month, and sometimes more than twice a month. In September, 20XX five transfers occurred. During the year \$ of transfers were made. No reason for these transfers was ever determined.

Another method of inurement was having the organization make payments on credit cards when personal charges had been made to the card. The statements were not available for most of the credit card accounts but all were available for the largest credit card account. This was the CO-5 account ending in #. The organization made almost \$ of payments on this account alone. When the account was analyzed it was found that more than % of the purchases made in the test sample were personal in nature. The bank deposit analysis also found that \$ of payments were made to a CO-6 credit card. These payments were made up of twelve \$ payments made monthly. No exempt function purpose was ever determined for these payments because records (account statements) were not available. In regard to the CO-7, all of the purchases were found to be personal in nature.

Inurement also occurred by making transfers directly into the personal checking account of Founder. According to the organization's primary bank account \$ of transfers were made to this bank account during 20XX. No legitimate exempt purpose of these transfers was ever determined.

The lack of oversight by an independent oversight board and the lack of internal controls resulted in an environment where Founder could do as she pleased without having to answer to anyone. The result was that Founder could treat the organization as her personal checking account.

This abusive environment was further enabled by Founder when she hired a preparer who seemed determined to keep himself in ignorance about the operations of the organization. RA-1 passed off the bookkeeping to an employee who wasn't interested enough in the organization to even enquire about the transfers Founder was making to her personal and business bank accounts. This was further seen during the initial interview when RA-1 was unable to provide much specific information about the organization or its' activities.

Conclusion:

During the examination of ORG a number of conclusions were reached.

First, it was determined that no exempt purpose was being fulfilled. The organization operated in a manner consistent with a private psychologist. In this particular case the payments were received from the State of State rather than the patient or insurance company. No evidence was

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seen that the organization ever helped anyone other than the people who received state benefits. In addition, it was not seen that the organization ever attempted to reach out to the public or to children or others who may be in need of these types of services. Nothing was seen to support Founder statement that the organization treated some patients for free. In short, the organization operated in a manner that lacks any exempt purpose.

In addition, it was concluded that the organization failed to keep and maintain adequate books and records that could support its' tax return as required by the Code and Regulations. Further, the tax return contained significant errors. This includes the problem of decreasing assets shown on the return when increases should have been reflected as stated above. A simple review would have found this problem. Another significant problem arose with the bookkeeper, RA-2, arbitrarily decided to classify transfers to Founder and to Founder for-profit practice as loans when no evidence of a loan existed. RA-2 stated that he had not seen or was aware of formal loan agreement. According to RA-2 this decision was his.

One of the most fundamental justifications for revocation is the inurement which occurred in several manners. Founder made a great many personal purchases on credit cards and the paid the credit card bills from the organization's funds. The organization made more than \$ of payments on credit cards that result in inurement. Founder also made routine transfers from the organization's checking account to her own account. No explanation was found for this. No 1099-Misc. or W-2 was issued by the organization to show these payments were earned income of some fashion. The only conclusion that could reasonably be made is that she simply took money from the organization. Founder also transferred money from the organization to her for-profit practice. No explanation of this was provided by the organization or found. A 1099-Misc was issued from the organization to the for-profit practice but the amount was short by \$. It was never clear what the for-profit practice did to earn any money.

Just from the credit cards alone inurement was in excess of \$.

In order to remain exempt from taxes an organization must put precautions in place to protect the assets of the organization. The organization fell completely flat on this. There was no independent oversight board to provide guidance to the organization. In addition, Founder appointed herself to all of the officers positions.

Because of the manner in which Founder set up the organization without oversight or controls and the manner in which Founder routinely pilfered the accounts of the organization fraud was seriously considered.

Ultimately it was concluded that the exempt status of ORG should be revoked because it fails to meet the requirements for exemption and provided by the Code and related Regulations.

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Please file US Corporate income tax return Form 1120 for the tax periods ending December 31, 20XX, December 31, 20XX, December 31, 20XX and December 31, 20XX.

Contributions to your organization are not deductible under IRC 170.

Please note that this is not a final report. The draft report is subject to review and modification by our Mandatory Review staff. You will receive a final report from Mandatory Review.